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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 509

OTTO A. KOHL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 23-31) is not reported. The opinion of the Court of Appeals (R. 150-159) is reported at 170 F. 2d 531.

JURISDICTION

The judgment of the Court of Appeals was entered November 12, 1948. (R. 159-160.) Taxpayer's petition for rehearing was denied December 6, 1948. (R. 169.) The petition for a writ of cer-

tiorari was filed January 13, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that business income attributed by taxpayer to a trust for the benefit of his wife and children under a so-called partnership agreement was includible in taxpayer's gross income as defined in Section 22 (a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 12-14.

STATEMENT

The facts as found by the Tax Court (R. 23-31) may be summarized as follows:

From 1933 until 1941 (the taxable year) taxpayer conducted, as sole proprietor, a business of bottling and distributing liquefied petroleum gas for domestic use. (R. 23.) He was married and had three minor children, the eldest of whom was seventeen years old in 1941 and was attending college. (R. 25.)

In 1935 taxpayer employed one Van Meter to perform office work, and in 1936 he employed one Cobb as an accountant. Early in 1941 Van Meter was designated general manager of the business, and Cobb was designated comptroller. Taxpayer enlarged the duties and responsibilities of these

employees in order to devote more of his time to the development of new products. By April of 1941 taxpayer had practically relinquished the routine management of the business to these employees, and devoted between 25 and 30% of his time to the promotion of new products. He retained, however, the right to make all major decisions affecting the business, and Van Meter and Cobb consulted him frequently. Van Meter's salary was $2,850 in 1941 while Cobb's salary was $2,400. (R. 23-24, 29.)

On April 21, 1941, taxpayer executed an irrevocable trust agreement naming Van Meter and Cobb as trustees, and his wife and children as beneficiaries. On April 30, 1941, taxpayer executed a partnership agreement with Van Meter and Cobb as trustees, whereby he purported to sell to them as trustees a 49% interest in his business, in consideration of $44,273 (representing 49% of the book value of the business) evidenced by a promissory note payable within ten years at 2% interest. The note was payable only from net profits of the business, and the net profits were to be apportioned 51% to taxpayer and 49% to the trust. Under the trust instrument the trustees were given control over the trust property, but were expressly prohibited from making any sale or investment during taxpayer's lifetime without taxpayer's written approval. (R. 24-26.) Under the partnership

agreement taxpayer (referred to as the "First Party") reserved (R. 26)—

> the right to determine all questions of buying or selling either real or personal property, or renting the same, or any part thereof, and pledging the credit of the Company whenever he deem it necessary, in the exercise of his judgment and discretion necessary and proper to do so, and to determine credits to be extended by the Company in the carrying on and conduct of its business and the pledges of credit to be taken by the Company to secure any credits extended in order to preserve the rights and protect the interests of the Company, and that whenever a question arises about which there is a difference of opinion, as between or among the parties hereto, the ultimate determination of the First Party as to the course to be pursued in any such matter, shall be final and binding upon all of the parties hereto.
>
> * * *
>
> It is further agreed and understood between the parties hereto that First Party has, and is hereby given the right to determine the number of and who shall be the employees of said Bupane Gas Company, and the compensation to be paid to each and all of said employees at any time during the period covered by this contract.

Entries were thereafter made on the books of the business to reflect a 51% and 49% ownership

of its net worth by taxpayer and the trust respectively, and the business was registered as a partnership. (R. 27.)

The note given by the trust to taxpayer as the purchase price of a 49% interest in the business was paid by the business on behalf of the trust in three installments in 1942, 1943 and 1944. A bank account was first opened in the name of the trust in 1944, at which time monthly disbursements were made by the business to the trust account. The first distribution to the trust beneficiaries was made in 1946 in the form of paid-up life insurance for the beneficiaries. Van Meter and Cobb received trustees' fees of $2,000 each from the trust in 1944, 1945 and 1946. (R. 27-28.)

The trust invested no capital originating with it, and had none to invest; the trustees merely purported to purchase a partnership interest from taxpayer, and paid for such interest out of the profits allocated to the trust as a partner. Nor did the trustees contribute any vital additional services to the business, managerial or otherwise. As employees they had performed managerial and other vital services, and after purporting to become trustee-partners they continued as employees to perform the same services. They participated in the management of the business only as employees, not as partners; and they were paid salaries for their services as employees, not as partners. Taxpayer reserved to himself control over the

business, and in practice he exercised such control. (R. 29.)

A fiscal year ending January 31 was adopted for the business, and a partnership return was filed for the nine-month period May 1, 1941, to January 31, 1942. Of the net profits 51% was allocated to taxpayer, and 49% to the trust. The trust adopted a fiscal year ending October 31, and reported 49% of the profits for its fiscal year ending October 31, 1942; the tax on the income reported by the trust was paid by the business. The Commissioner disregarded the alleged partnership between taxpayer and the trust and determined that the entire net income of the business for the eight-month period May 1 to December 31, 1941 (i.e., eight-ninths of the income reported by the "partnership" for the nine-month period ending January 31, 1942) was includible in taxpayer's 1941 gross income. (R. 27-28.) The Tax Court, relying on *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, sustained the Commissioner's determination. (R. 28-31.) The Court of Appeals affirmed. (R. 151-159.)

ARGUMENT

There is no occasion for further review. This case is controlled by *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, with which the decision below is in complete accord.

1. The question here is the same as that resolved in the *Tower* and *Lusthaus* cases, *supra.* This Court there held that partnerships predicated upon intra-family transfers of business capital are without federal income tax significance, though valid under state law and as to third parties, if the arrangement produces no substantial change in the creation of the business income but merely a reallocation of it within the family. Unless the transferee-partner "invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the Tax Court is fully justified in concluding that the claimed partnership lacks economic reality. In the *Tower* case a gift by a husband to his wife of a portion of his business capital was held ineffectual to render the wife his partner for tax purposes. In the *Lusthaus* case this Court held that no different result obtains where the husband purports to sell some of the capital to his wife for a consideration payable partly with donated funds and partly out of the share of the business income ascribed to her as a partner. The principles underlying these decisions apply with full force where, as here, the transfer is made in trust for the benefit of members of the taxpayer's family and the ensuing partnership agreement is with the trustee; passage of titular ownership of some of

the husband's business capital to a trustee instead or directly to the donee affects the legal form, not the economic substance, of the arrangement. *Hash v. Commissioner,* 152 F. 2d 722 (C.A. 4), certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879; *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C.A. 3), certiorari denied, 332 U. S. 767; *Belcher* v. *Commissioner,* 162 F. 2d 974 (C.A. 5), certiorari denied, 332 U. S. 824; *Economos* v. *Commissioner,* 167 F. 2d 165 (C.A. 4), certiorari denied, 335 U. S. 826; *Dawson* v. *Commissioner,* 163 F. 2d 664 (C.A. 6); *Benson* v. *Commissioner,* 161 F. 2d 821 (C.A. 5); *Losh* v. *Commissioner,* 145 F. 2d 456 (C.A. 10); *Quon* v. *Commissioner,* 165 F. 2d 215 (C.A. 9).

As is plain from its opinion, the Tax Court applied the test prescribed in the *Tower* and *Lusthaus* cases. It addressed itself to the crucial question of whether the trust which taxpayer created for the benefit of his wife and children, and which he purported to make his partner, contributed any new capital or services (managerial or otherwise) to the business. It concluded (R. 28-30) that neither of these alternative requirements had been met and, as the court below pointed out (R. 155-159), the evidentiary support for that conclusion is unassailable. As for the capital allegedly contributed by the trust, it consisted of nothing more than a portion of the capital already invested by taxpayer in

the business; taxpayer merely purported to "sell" 49% of his interest to the trust in exchange for a note payable out of a corresponding percentage of the business profits ascribed to the trust as his "partner". (R. 25-26, 27, 29.) Cf. *Lusthaus* v. *Commissioner, supra.* As for the vital additional services allegedly contributed by the two employee-trustees, they consisted of nothing more than a continuation of the same services already being performed by them *qua* employees; indeed, the only payments made to them by the business were made to them as employees, not as partners. (R. 24, 29.) What is more, under the partnership agreement taxpayer expressly reserved the right to determine all important policy matters affecting the business, as well as the right to terminate the services of the employee-trustees. (R. 26, 29.) And he in fact exercised such control. (R. 24, 29.) In short, after formation of the "partnership" the business was carried on in substantially the same manner as before. The employee-trustees became "partners" in name and on paper only. "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided". *Commissioner* v. *Tower, supra,* p. 291. Here, as in the *Lusthaus* case (p. 297), "the partnership arrangements were merely superficial, and did not result in changing the husband's economic interest in the business". Since the Tax Court applied the correct principles, and

its decision has solid evidentiary support, affirmance by the court below was clearly correct.

2. In *Commissioner* v. *Culbertson*, No. 313, certiorari granted December 6, 1948, upon which taxpayer chiefly relies (Pet. 10), the Tax Court followed this Court's holding in the *Tower* and *Lusthaus* cases, but the Court of Appeals reversed. The case called for further review because, as pointed out in the Government's petition for certiorari, if the decision of the Court of Appeals were allowed to stand it would seriously undermine the *Tower* and *Lusthaus* decisions. See also petition for certiorari in *Commissioner* v. *Hartz*, No. 520, filed January 25, 1949. Here both courts below have adhered to the *Tower* and *Lusthaus* decisions, and there is no more occasion for further review of this case than of similar family trust-partnership cases (*Hash* v. *Commissioner, supra; Eisenberg* v. *Commissioner, supra; Economos* v. *Commissioner, supra; Belcher* v. *Commissioner, supra*) in which certiorari has been denied.

3. Taxpayer's contention (Pet. 14-15) that the decision below unconstitutionally taxes him on the income of another begs the issue. The income in question is taxable to taxpayer, rather than to the trust-partner, because it was earned by taxpayer. To permit the tax consequences to turn upon the considerations stressed by taxpayer would sanction the very type of formalism which this Court

in the *Tower* and *Lusthaus* cases refused to recognize as effectual to alter tax liability.

CONCLUSION

The decision below is in accord with the decisions of this Court in the *Tower* and *Lusthaus* cases, and there is no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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February, 1949

Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.

(26 U. S. C. 1946 ed., Sec. 11.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U. S. C. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

*   *   *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

*   *   *

(26 U. S. C. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any

source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

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